



INVESTMENTS BY VENTURE CAPITAL FUNDS AND FOREIGN VENTURE CAPITAL FUNDS IN INDIA: A COMPARATIVE STUDY

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ABSTRACT

In the year 1996, the government for the first time gave an organisational shape to the needs of the unlisted companies and Greenfield projects in India and the Venture Capital Industry was formalised. Prior to 1996 also World Bank aimed at helping small, innovative firms to obtain innovative resources by building the regulatory and institutional framework for venture capital in India. World Bank, in fact, started venture capital initiative too by providing assistance to Industrial Credit and Investment Corporation of India Ltd. (ICICI), Canara Bank, the State Industrial Development Corporation (SIDC) of Andhra Pradesh (APIDC) and Gujarat (GIIC) for opening up venture funds. Although this initiative by the World Bank was able to give the Indian innovative firms some form of assistance, the criterion to get venture funds as laid down was too restrictive and the regulatory aspect was also too clumsy. It was only after the release of Securities and Exchange Board of India (Venture Capital) Regulation, 1996 and Securities and Exchange Board of India (Foreign Venture Capital) Regulation, 2000 that the venture capital industry took a formal shape in India. It has been twenty years since the formalisation of the venture capital industry here. Unlike the middle nineties and even the early twenties, when foreign investors were too reluctant to invest in Indian projects, today the Indian ventures are not in dearth of foreign funds. In fact, this study finds that, from the later part of the last decade foreign investors have been playing pivotal role in providing financial assistance to Indian unlisted companies. Results from this study also find significance difference in the investment behaviour of foreign and domestic venture funds across the sectors over the study period. It has also been observed by the researcher that in the last nine years, investments from the foreign venture funds have experienced quintessential growth in the country and has even surpassed the domestic funds by a huge margin.

I. INTRODUCTION:

In the year 1991, the Indian economy liberated itself and implemented the historic liberalisation, privatisation and globalisation policy out of a fiscal collapse. Sixteen years later, today, the same economy is considered as the fastest growing economy in the world. It has the world's largest IT market and second largest telecommunication market. This economy has gone through some massive structural transformations. Agriculture is no longer the dominating sector in the economy and secondary and tertiary sectors have surpassed the primary sector. Entrepreneurship has become one of the driving wheels of the modern day Indian economy (Koster, Rai, 2008). Researchers have found that opportunity entrepreneurship, which is an active choice to start a new enterprise based on the perception that an unexploited or underexploited business opportunity exists, has a positive and significant effect on economic development (Shrivastava, Shrivastava, 2013). Given the increasing significance and visible impact of entrepreneurship in wealth-creation and employment-generation, National Knowledge Commission has also declared it critical to India's growth and development (Entrepreneurship in India, 2008). Entrepreneurship introduces a critical element of dynamism into an economic system (Swetha, Rao, 2013). Koster and Rai (2008) have even suggested that increasing the quality of entrepreneurs should be the main focus of policy measures. However, the aim of this study is not to examine the impact of entrepreneurial activity upon economic growth and development of India. Rather, this study aims at assessing external financial opportunities available to start ups in the form of venture financing. Venture financing is provided to start up enterprises that show a strong potential to grow. It has a risk element involved in case the portfolio company receiving the fund fails to cope up with the expected growth potential. Venture capital is a broad institutional process involving primarily three agents – the investor or the limited partner who are wealthy individuals, private and public banks, insurance companies, pension funds, big corporate houses or any such cash rich institution willing to invest their money on potential enterprises; the active partner or the venture capitalists which is an organised sector and is either a company or trust or body corporate who proposes to carry on any activity as a venture capital fund and the venture capital undertaking or portfolio company or investee firm or potential enterprise which is not listed in any recognised stock exchange of India at the time of making investments and which is engaged in the business of providing services, production or manufacturing of article or things and does not include in activities in the non-banking financial companies, gold financing, activities not permitted under the industrial policy of government of India and any other activity which may be specified by the Securities and Exchange Board of India in consultation with the Government of India from time to time.

Any company or trust or body corporate who proposes to carry on any activity as a venture capital fund needs to make an application to SEBI for grant of a certificate. Once the Board is satisfied, they shall grant the certificate to the "Venture Capital Funds". Such certificates may be granted either to a domestic investor or to a foreign investor incorporated and established outside India and who proposes to make investments in venture capital funds or venture capital undertakings in India. Accordingly, there are 208 SEBI registered domestic venture capital funds and 154 foreign venture capital funds in India now. The foreign venture capital funds are regulated by the Securities and Exchange Board of India (For-

eign Venture Capital Investors) Regulations, 2000. The Foreign Venture Capital Investors/ Funds (FVCI/FVCF) are allowed to invest on potential enterprises originating in India under the FDI Scheme, as non-resident entities, in other companies, subject to FDI Policy and FEMA regulations (Consolidated FDI Policy, 2015) or through the Securities and Exchange Board of India, it can apply to the Reserve Bank for permission to invest in Indian Venture Capital Undertaking (IVCU) or in a VCF or in a scheme floated by such VCFs (Foreign Exchange Management, 2000). However, by Foreign Exchange Management (Transfer or Issue of Security by a Person Resident outside India) (Third Amendment) Regulations 2016, it was declared that an FVCI registered under the SEBI (FVCI) Regulations, 2000 shall not require any prior approval of RBI for investments made under Schedule 6 of the amendment act (Foreign Exchange Management Regulations, 2016). By a recent consolidated FDI policy effective from August 28, 2017, FDI cap for FVCI has been raised to 100 percent from 49 percent. On the other hand, the domestic venture capital regulations were regulated by Securities and Exchange Board of India (Venture Capital Investors) Regulations, 1996. But, in the year 2012, this regulation was merged with the Securities and Exchange Board of India (Alternative Investment) Regulations 2012 and the funds registered as venture capital fund under Securities and Exchange Board of India (Venture Capital Funds) Regulations, 1996 continued to be regulated by the said regulations till the existing fund or scheme managed by the fund is wound up (SEBI, 2012). Since 2012, the venture capital funds have been included in the "Category I Alternative Investment Fund" and are regulated by the Securities and Exchange Board of India (Alternative Investment) Regulations 2012. These venture capital funds, both fuelled by domestic as well as foreign investors, have quintessential impact over their portfolio companies as they do not act merely as a supplier of funds but also provide the enterprises with necessary technical, managerial, product and market related aspect. Of late, especially after the turmoil of global recession, the Indian venture capital market has seen an increasing influx of foreign investments in the potential Indian companies. In fact, investments from foreign investors have consistently been higher than that of Indian investors for almost seven/ eight years consecutively now. Under these backdrops, this study makes an attempt for a comparative study of the domestic venture capital investments vis a vis foreign venture capital investments.

II. OBJECTIVES OF THE STUDY:

This study aims to fulfil the following objectives:

1. To determine the share of domestic and foreign venture capital investments in the total venture capital investments in India.
2. To find out whether there is any significant difference in the investments of SEBI registered domestic and foreign venture capital funds in India.

III. HYPOTHESES:

In order to achieve the above stated objectives the following hypotheses have been formed:

H_0 : There is no significant difference between mean percentage of investments by VCF and FVCI across the study period, i. e. all the row means are equal

H₀: There is no significant difference between mean percentage of investments by VCF and FVCI among different industries, i. e. all the column means are equal

IV. DATA AND METHODOLOGY:

The data used in this study have been collected from the various editions of annual Handbook of Statistics of Securities and Exchange Board of India. Some data relating to the regulatory aspect of the venture capital industry have been collected from the Ministry of Commerce & Industry, Department of Industrial Policy & Promotion.

The researcher encountered asymmetry of information relating to venture capital industry in India. Systematic information regarding investment levels by registered Domestic Venture Capital Funds and Foreign Venture Capital Funds are available in the SEBI website only from 2006-07. The IVCA reports, although, give certain information regarding venture capital and private equity investments since 2000, they are found to be inconvenient for the present study as those

do not furnish systematic information about the domestic and foreign venture capital funds separately. Considering these facts, the time period of 2006-07 to 2015-16 have been chosen for the study.

The data thus collected have been tested with simple statistical tools like percentage method, arithmetic mean and ANOVA. To calculate the average growth of Venture Capital Funds (VCF) and Foreign Venture Capital Funds (FVCF) in terms of investments made in companies originating in India, the following formula has been used:

$$\left\{ \frac{\text{investments made in the last year under consideration}}{\left(\frac{\text{Investments made in the first year under consideration}}{\text{Total years}} \right)} - 1 \right\} * 100$$

V. FINDINGS AND RESULTS:

The following table gives the investment details of Venture Capital Fund (VCF)s and Foreign Venture Capital Fund (FVCF)s during the study period.

Table 1: Investments by Venture Capital Fund (VCF)s and Foreign Venture Capital Fund (FVCF)s in Indian start ups:

(Amounts in rupees crores)			
Year	VCF	FVCF	Total Investments
2006-07	11270	7856	19126
2007-08	19955	16705	36660
2008-09	22,771	23,047	45,818
2009-10	18273	28894	47,167
2010-11	25576	35593	61,169
2011-12	28919	39816	68,735
2012-13	31337	41174	72,511
2013-14	35986	45263	81,249
2014-15	36563	44517	81,080
2015-16	35986	45263	81,249
Average growth during the study period	24.37	52.91	36.08

Source: Author's calculation on the basis of data collected from Handbook of Statistics, SEBI, Various editions.

The investment data released by SEBI in its annual Handbook of Statistics on Information Technology and Information Technology Enabled Services (IT and ITES), Telecommunications, Pharmaceuticals, Biotechnology, Media and Entertainment, Services, Industrial Products, Real Estate and other (agriculture, textiles & garments, chemicals, e-commerce etc.) sectors reveal that both the domestic and foreign venture capitalists have been showing growing confidence on Indian Greenfield projects. Overall, venture investments in the country have seen a 36 percent growth during the study period. The FVCFs have seen a tremendous growth of 53 percent during the study period against 24 percent growth in the domestic VCFs. A close look at the above data reveals that during the first two years under consideration viz. 2006-07 and 2007-08, domestic venture funds have been more prominent than their foreign counterparts. The shift started in 2008-09 and then continued consistently thereafter. Even during the economic meltdown of 2008-09 and 2009-10, the foreign investors showed quintessential faith upon Indian start ups. The following chart will give a better idea of the scenario.

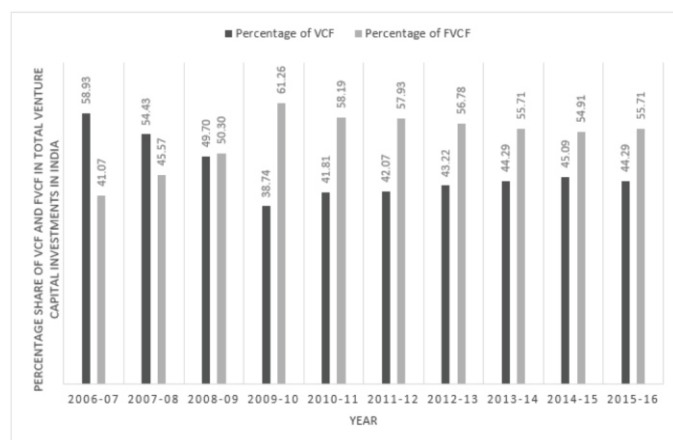


Fig.1: Percentage of VCFs vis a vis FVCFs in India

Thus, barring the years 2006-07 and 2007-08, the FVCFs have consistently been more prominent in providing funds to India start ups. The fact that has become interesting to the researcher is the higher percentage of investments by the FVCFs during the economic slowdown. Explanation to this may be found in the domesticated nature of the economy. In fact, India, China, Indonesia and South Korea are the only Asian countries which were declared to have escaped the great

depression on the basis of quarter on quarter changes of seasonally adjusted real GDP (Great Recession, n.d.). Thus, although India saw a temporary slowdown during the years of recession, the economy did not collapse like the economies of many developed nations.

The trend that started in the year 2008-09 has been continuing ever since and the foreign venture capital funds have consistently been supplying more than 50 percent of the funds to the startup companies originating in India. India's high growth prospects have made India a favored destination for limited partners to park their money. Especially India's advancement in IT industry and the availability of cheap labour has made India one of the most profitable destinations. With the growth in technology industry, the demand for technocrats and commercial and retail accommodation has also been growing which have created a derived demand in the education, real estate and other sectors also.

This faith of the foreign investors upon Indian start ups appeared to be interesting to the researcher and therefore, the researcher tried to envisage the factors leading to the growing interest of foreign limited partners on the Indian subcontinent. It appears that the global economy has been experiencing many upheavals. US has experienced fiscal cliff, debt ceiling crisis, six day government shutdown, Europe has been tangling with the repercussions of the euro zone crisis of 2009. Accordingly, the global GDP has been maintaining a slow but stable growth rate in the range of 1.5 percent to 2.5 percent. The BRICS (Brazil, Russia, India, China, South Africa), on the other hand, have been able to manage a somewhat better growth at the range of 4.5 percent to 6 percent. Within the BRICS countries, India is growing at a faster rate. In the financial year 2015-16, whereas BRICS grew at 4.5 percent, India saw a growth rate of 7.6 percent (IVCA Report, 2017). This growth is mostly led by increases in the financial, insurance, real estate, manufacturing and online retail business which have contributed 54 percent to the GDP last fiscal. India is ranked seventh in terms of nominal GDP in the world and third in terms of purchasing power parity (PPP). The increasing opportunities and a somewhat buoyant macroeconomic environment have made India a favorable destination for limited partners to park their money. India has been quoted as more attractive destination than other countries in the VCCircle India Limited Partners Summit held in February, 2015. Karthik Reddy, managing partner at venture firm Blume Ventures stated that limited partners are quite happy with the track record of venture funds out here in India (Dhanjal, Sarkar, 2015).

The encouraging factor for investors that is allowing them to further expand their investment base to India is that this growth trajectory is expected to continue. By 2020, the Indian economy is expected to grow at a rate 7 to 8 percent which is double the global rate and four times the developed nations and will reach \$ 3 trillion which may overtake France and UK (Nair, 2017). Schemes like Make in India, industrial corridors, smart city, investment and manufacturing zones are

expected to increase the manufacturing sector's share in GDP to 25 percent in the next five years. The foreign investors are mostly eyeing on India's growing technology sector. Anand Prasanna, director at Morgan Creek Capital Management, LLC addeed "Going ahead, we are looking to increase our allocation to India. However, it won't be across the board. We are most bullish on the tech sector and that is where most of the increased allocation will go." (Dhanjal, Sarkar, 2015). Going by this, the buoyant growth rate of IT and ITES sector which is expected triple its current annual revenue to reach US\$ 350 billion by FY 2025 (IT & ITeS Industry in India, 2017), may probably indicate to a further increasing flow of venture funds from foreign investors. Pension funds and sovereign wealth funds have been the most sophisticated investors of venture financing. Considering this, higher foreign ownership in insurance, liberalization of corporate bond market and especially broader mandate to include equities and alternative assets have also opened the gateway for venture investors to flagship in Greenfield projects. In a recent LP survey among the North American and European pension funds as well as leading sovereign wealth funds from the Middle-East and Asia, one in three investors said they are targeting investments in India, up from one in four last year (Nair S., 2017). Brooks Preston, head of the US government's development finance institution, Overseas Private Investment Corporation (OPIC) has also stressed in broadening their investment base in India "We definitely want to increase our allocation to India and South-East Asia as compared to the other geographies," (Dhanjal, Sarkar, 2015).

A foreign venture capitalist can invest whole of its funds into a single venture capital undertaking. The SEBI Foreign Venture Capital Investors (Amendment) Regulations, 2004 has omitted the words "it shall however not invest more than 25% of the funds committed for investments to India in one Venture Capital Undertaking" and accordingly in chapter III of Securities and Exchange Board of India (Foreign Venture Capital) Regulations 2000, it has been clearly mentioned that "it can invest its total funds committed in one venture capital fund" (SEBI, 2000). However, the Securities and Exchange Board of India (Venture Capital Funds) Regulations 1996 that has been monitoring the domestic venture investments for

long stated that "venture capital fund shall not invest more than 25% corpus of the fund in one venture capital undertaking" (SEBI, 1996). The Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012, which is guiding the rules and regulations for venture capital investments now also clearly mentions that "Category I and II Alternative Investment Funds shall invest not more than twenty five percent of the corpus in one Investee Company" (SEBI, 2012).

Although venture funds from foreign sources have seen significant growth, 52.90 percent to be precise over the study period, the domestic venture funds have also been able to grow their investment base by 24.36 percent. No doubt, the foreign venture funds are smaller in number at 154 compared to 208 domestic venture funds; but, the foreign funds are far more superior and experienced and most importantly huge than their Indian counterpart. Indian venture funds have been surcharged by problems like difficulty in fund raising, inexperienced management etc.. Most of the top venture funds in India like Accel Partner, Nexus Venture Partners, Helion Venture Partners, Intel Capital, Sequoia Capital India, Investus Capital Partners, Fidelity India Ventures etc. are foreign venture funds investing on Indian enterprise. There are very few domestic funds such as Blume Ventures, Kae Capital, Canbank Venture Capital Fund etc. which could match the prominence of these foreign funds. Considering this, the rate of increase in investments by domestic funds is not dissatisfactory at all. In order to check whether there is any significant difference in investment by venture funds of foreign and Indian origin, ANOVA two factor without replication has been performed for the following hypothesis:

H₀₁: There is no significant difference between mean percentage of investments by VCF and FVCI across the study period, i. e. all the row means are equal

H₀₂: There is no significant difference between mean percentage of investments by VCF and FVCI among different industries, i. e. all the column means are equal

Table 3: ANOVA Results

Source of Variation	SS	df	MS	F	P-value	F crit
Variation Between Rows	2080055614	9	231117290.5	13.4974	0.00032	3.17889
Variation Between Columns	189063303.2	1	189063303.2	11.0414	0.0089	5.11736

Source: Author

At 95 percent confidence level, the critical value of F for df=9, the critical value of F is 3.17889. The calculated value between rows is 13.4974 which is greater than the critical value and hence falls in the rejection region. Therefore, the null hypothesis H₀₁ is rejected and the researcher encounters significant difference between mean percentage of investments by VCF and FVCI across the study period. Similarly, hypothesis H₀₂ is also rejected and the researcher concludes that there is significant difference between mean percentage of investments by VCF and FVCI among different industries.

VI. CONCLUSION:

Increases in venture investments, be it from foreign sources or from domestic sources is vital for India's small and emerging business houses which do not have proper access to the debt market and require managerial, technical and product related assistance at various stages of growth of its business. Ever since the reforms of 1991, India has left to live in isolation and has been promoting integration with outside economies. The government of India has introduced a chain of policies to attract foreign funds into the country. Under such backdrops, increasing availability of foreign funds for Greenfield projects in India is a boost up for the entrepreneurial environment in the country. It shows the investors' confidence on the new ventures. Moreover, since venture funds impart technological and managerial assistance also, increased foreign venture funds may become handy for accessing the advanced technologies of the developed countries. Besides, the best global practices of management could also be garnered by the Indian enterprises from their parent foreign venture funds. With access to advanced and improved technologies and managerial ideas, the competitiveness of these enterprises is expected to increase. Besides, foreign venture funds have been a major source of Foreign Direct Investments (FDI) into the country. To talk in numbers, during the years 2006-07 to 2015-16 around 19 percent of the FDI into the country has accrued from foreign investments in unlisted companies in India (Author's computation). To conclude, the strong growth potential of India especially in the technology sector has put her as the favourite destination for limited partners to park their money. If the growth sustains, and the major sectors of the economy are able to achieve the forecasted luring growth dimensions, India well has the potential to attract huge venture investments and to become the entrepreneurial hub of the east.

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